

Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

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JUL 1 - 1992

Federal Communications Commission  
Office of the Secretary

In the Matter of

Treatment of Local Exchange  
Carrier Tariffs Implementing  
Statement of Financial Accounting  
Standards, "Employers' Accounting  
for Postretirement Benefits  
Other Than Pensions"

Bell Atlantic  
Tariff F.C.C. No. 1

U S WEST Communications  
Tariff F.C.C. Nos. 1 and 4

Pacific Bell  
Tariff F.C.C. No. 128

ORIGINAL  
FILE

CC Docket No. 92-101

Transmittal No. 497

Transmittal No. 246

Transmittal No. 1579

AT&T OPPOSITION TO DIRECT CASES

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July 1, 1992

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## TABLE OF CONTENTS

	<u>Page</u>
SUMMARY . . . . .	i
BACKGROUND . . . . .	3
I.    THE LECS HAVE NOT SHOWN THAT THEIR SFAS 106 ACCRUALS DO NOT "DOUBLE COUNT" OPEB-RELATED COSTS THAT WILL BE RECOVERED THROUGH GNP-PI . . . . .	5
A. Godwins' Study Of The Double Count Is Seriously Flawed . . . . .	8
B. The Commission Should Require The LECS To Remove The Double Count From The SFAS 106 Accrual Using The Method Suggested Herein . . . .	12
II.   ONLY PREFUNDED OPEB COSTS SHOULD BE CONSIDERED FOR EXOGENOUS TREATMENT . . . .	14
III.  SOME LIMITATIONS SHOULD BE PLACED ON THE LECS' SFAS 106 ACCRUALS FOR EXOGENOUS PRICE CAP TREATMENT PURPOSES . . . . .	16
CONCLUSION . . . . .	30
APPENDICES	

## SUMMARY

In their direct cases, the price cap local exchange carriers ("LECs") seek to justify exogenous cost treatment for their SFAS 106 accruals for postretirement benefits other than pensions ("OPEB"). Should the Commission grant the full measure of exogenous treatment that these carriers seek, the overall increase in price cap indices would be approximately \$247 to \$294 million annually. AT&T's Opposition demonstrates that the LECs have failed to meet their burden of demonstrating that exogenous treatment of these expenses is justified.

First, as shown in Part I, the LECs have not demonstrated that their SFAS 106 accruals do not double count OPEB-related costs that will be recovered through GNP-PI. The double count occurs because the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect increasing OPEB costs through higher prices, and because the SFAS 106 accrual calculation includes the present value of future inflation. The LECs' reliance on the Godwins and NERA studies as a basis for demonstrating that they have not double counted is unavailing, because those studies are seriously flawed in numerous respects. The Commission therefore should remove the double count from the SFAS 106 accrual by requiring the LECs to subtract the expected rate of change of GNP-PI

from the health care inflation component in the SFAS 106 accrual.

Part II shows that only OPEB costs that are actually prefunded should be considered for exogenous treatment. This is necessary because nothing prevents a LEC from recovering SFAS 106 accrual costs and then, in the future, reducing the actual benefits paid or even paying no benefits at all. A mandatory prefunding requirement would ensure that amounts paid by ratepayers are used only for the purpose for which exogenous treatment was granted.

Part III demonstrates that, as a general matter, some limitations should be placed on the LECs' SFAS 106 accruals for exogenous price cap treatment purposes. Although SFAS 106 accounting treatment is mandatory, the LECs' direct cases show that the underlying OPEB expense is not totally outside the LECs' control and that they are able to vary the level of OPEB benefits provided to their employees. In these circumstances, giving the LECs guaranteed recovery of the full amount of their SFAS 106 accruals would reduce their incentives to control their costs, contrary to a fundamental objective of the Commission's price cap policy. Moreover, the LECs' filings show that there exist significant variations among the LECs as to the OPEB cost control measures (e.g.,

capping of health care benefits), if any, that they have implemented. It would be unfair to give any company an unwarranted price increase due to its own delay in adopting cost-control measures. Full exogenous treatment would be inappropriate for the additional reasons that OPEB accruals are inherently very speculative and unreliable and because such treatment could result in the LECs receiving unearned windfalls. The Commission therefore should limit the LECs' OPEB accruals for pricing purposes by adopting certain parameters to be used by all LECs in calculating the amount of their OPEB expenses entitled to exogenous treatment. The LECs would, of course, remain free to offer their employees whatever OPEB benefits they deem appropriate and to reflect the full amount of the associated SFAS 106 accruals on their regulated income statements.

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AT&T OPPOSITION TO DIRECT CASES

Pursuant to the Commission's Order of  
Investigation and Suspension, 7 FCC Rcd. 2724 (1992)  
("Investigation Order"), American Telephone and Telegraph  
Company ("AT&T") opposes the direct cases filed by each of  
the price cap local exchange carriers ("LECs").\*

In their direct cases, these LECs seek to justify  
revising their interstate access rates and Price Cap  
Indices to account for, as an exogenous cost change, the  
adoption of Statement of Financial Accounting Standards

\* A list of the parties filing direct cases and the  
abbreviations used to identify them are included in  
Appendix A.

No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("SFAS 106").\* Should the Commission grant the full measure of exogenous treatment that these carriers seek for their SFAS 106 accruals, the overall increase in price cap indices would be approximately \$123.5 to \$147 million for the period January 1, 1993 through June 30, 1993, and \$247 to \$294 million annually.\*\*

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\* SFAS 106 is published by the Financial Accounting Standards Board, Financial Accounting Series, No. 098-D (December 1990). In 1990, AT&T had sought exogenous price cap treatment for its other postretirement benefits ("OPEB") costs, based on early adoption of SFAS 106. The Commission denied exogenous treatment, because adoption of SFAS 106 at that time was not mandated by the Financial Accounting Standards Board ("FASB") or the Commission. See AT&T Revisions to Tariff F.C.C. Nos. 1, 2 and 13, 5 FCC Rcd. 3680 (1990) ("AT&T SFAS 106 Order"). Subsequent to release of the AT&T SFAS 106 Order, the Commission has provided additional guidance as to the requirements that must be shown before costs can be treated as exogenous. Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd. 665, 672, 674 (¶¶ 63, 74-75) (1991) ("AT&T Price Cap Reconsideration Order"); id., Order on Reconsideration, 6 FCC Rcd. 2637, 2664-65 (¶ 63) (1991) ("LEC Price Cap Reconsideration Order"). Those additional standards (e.g., exogenous costs cannot be already in GNP-PI) as well as the substantial control LECs have over their OPEB expenses and the necessarily speculative nature of the accruals dictate a careful scrutiny of the LEC OPEB accruals and require that certain limitations be placed on what accruals will be entitled to exogenous treatment.

\*\* These figures were derived as follows. The LECs generally identified the 1993 value of the exogenous cost increase in their direct cases. In those instances where the LEC stated that it was seeking exogenous treatment for only an identified portion of its incremental interstate OPEB expense, AT&T multiplied the incremental interstate OPEB expense by the percentage as outlined in the LEC's direct case to determine the annual increase in price cap indices. Further, if a LEC only identified the dollar value of

### BACKGROUND

SFAS 106 establishes new accounting standards for postretirement benefits other than pensions ("OPEB"), principally health care benefits. Prior to SFAS 106, companies generally booked OPEB benefits on a "pay-as-you-go" basis, based on the benefits paid on behalf of retired employees. SFAS 106 requires that these benefits be recognized as a form of deferred compensation for active employees and booked when the obligation to pay the benefits is incurred, i.e., earned by employees providing service. Thus, SFAS 106 requires companies to change from a cash basis of accounting (pay-as-you-go) to an accrual basis of accounting for OPEB. This change requires that accounting recognition be given to (i) benefits earned by employees (both currently active or now retired) in past years when the accrual method was not in use (the "transition obligation"), and (ii) the future benefits that active employees are currently earning. The FASB adopted SFAS 106 in December 1990, with conformance mandated for fiscal years beginning after December 15, 1992.

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its filing for the period January 1, 1993 through June 30, 1993, AT&T simply multiplied by two to determine the annual effect. The range is caused by the fact that NYNEX filed two SFAS 106 cost estimates (one based on capping of non-management health care costs at 1995 levels and one based on a projection without any capping). The figures presented in the text represent the annual, ongoing proposed price increase and do not include amounts for retroactive treatment sought by Bell Atlantic for the period prior to January 1, 1993.



The Commission has decided that it would incorporate changes in generally accepted accounting principles ("GAAP"), such as SFAS 106, into its regulatory accounting systems, provided that such changes do not conflict with its regulatory objectives.\* On December 26, 1991, the Common Carrier Bureau concluded that adoption of SFAS 106 for regulatory accounting purposes would not conflict with the Commission's regulatory objectives and authorized carriers to implement SFAS 106 on or before January 1, 1993.\*\* The Bureau further directed carriers to defer and amortize the transition obligation, *i.e.*, the unrecognized amount of the accumulated OPEB obligation as of the date SFAS 106 is initially applied, over a period of twenty years or the average remaining service period of active plan participants in accordance with SFAS 106.\*\*\*

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\* Revision of Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, 50 Fed. Reg. 48408, November 25, 1985. Section 32.16 of the Commission's Rules, 47 C.F.R. § 32.16, requires carriers to apply new standards adopted by the FASB and provides for automatic Commission approval of a new standard, unless the Commission notifies the carrier within 90 days after receiving notice of intention to follow a new standard that the new standard should not be adopted.

\*\* Southwestern Bell and GTE Service Corporation, Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, 6 FCC Rcd. 7560 (¶ 3) (1991).

\*\*\* Id., ¶ 4.

The Bureau's December 26, 1991 decision authorizing carriers to adopt SFAS 106 addresses only the issue of regulatory financial reporting;\* it does not address whether or not SFAS 106 costs are properly treated as exogenous for price cap purposes. In the LEC Price Cap Reconsideration Order,\*\* the Commission indicated that it will "consider requests for exogenous treatment" at the time the GAAP change for OPEB becomes effective.

I. THE LECS HAVE NOT SHOWN THAT THEIR SFAS 106 ACCRUALS DO NOT "DOUBLE COUNT" OPEB-RELATED COSTS THAT WILL BE RECOVERED THROUGH GNP-PI.

The Price Cap Rules\*\*\* allow for exogenous price cap treatment of GAAP-related changes provided the following criteria are met:

- 1) The GAAP change has been adopted by the FASB, found by the Commission to be compatible with regulatory accounting needs, and the change has become effective;\*\*\*\*

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\* Regulatory financial reporting includes, e.g., book entry into the Part 32 Uniform System of Accounts ("USOA"), expense recognition on the regulated income statement, Form 492 (the rate of return report), Form M and the ARMIS reports.

\*\* LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2664 (¶ 62).

\*\*\* Section 61.45(d) of the Commission's Rules, 47 C.F.R. § 61.45(d).

\*\*\*\* Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6807 (¶ 168) (1990) ("LEC Price Cap Order"), recon.

- 2) The cost change is outside the carrier's control;\* and
- 3) The cost change will not be reflected in GNP-PI (so that no double counting would occur if exogenous treatment were granted), and thus the change disproportionately affects telecommunications carriers.\*\*

The LECs have failed to demonstrate that the Commission's third criterion is met. To the contrary, the LECs' requests for exogenous treatment appear to reflect certain OPEB costs that will be reflected in the GNP-PI.

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denied, LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2663 (¶ 59), petition for review pending sub nom. D.C. Pub. Serv. Comm'n v. FCC, No. 91-1279 (D.C. Cir. filed June 14, 1991); AT&T SFAS 106 Order, 5 FCC Rcd. at 3680 (¶ 4).

\* LEC Price Cap Order, 5 FCC Rcd. at 6787, 6792, 6807 (¶¶ 5, 48, 166, 168).

\*\* LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2664-65 (¶ 63); AT&T Price Cap Reconsideration Order, 6 FCC Rcd. at 674 (¶¶ 74-75); Investigation Order, 7 FCC Rcd. at 2725 (¶ 6). Incentive-based price cap regulation rewards carriers who exceed a benchmark measure of cost changes, known as the Price Cap Index ("PCI"). The PCI includes three components: (1) an inflation measure (Gross National Product Price Index or "GNP-PI") which reflects economy-wide price changes, (2) a productivity offset to GNP-PI to reflect the historical productivity of the LECs which has exceeded that of the economy generally, and (3) exogenous cost changes. The PCI should be composed of cost indicators outside of any carrier's control. LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2667, n.77; Investigation Order, 7 FCC Rcd. at 2727 (¶ 5).

As the Commission correctly recognized, double recovery of OPEB expenses will occur unless the amount of any exogenous price increase excludes the OPEB-related price changes that will occur in the economy generally and which will therefore be reflected in the GNP-PI component of the PCI.\* The double count occurs because (i) the GNP-PI component of the PCI will increase as all firms with OPEB liabilities reflect those costs through higher prices, and (ii) the SFAS 106 accrual calculation includes the present value of future inflation. If the SFAS 106 accrual is afforded exogenous treatment, the amount of the accrual will be increased automatically in future periods due to growth in inflation as expressed by the GNP-PI component of PCI.\*\* Therefore, if inflation is included in both the exogenous cost component and GNP-PI, a LEC would be compensated twice. Although the LECs recognize this problem, no carrier has met its burden of showing that it has effectively removed this double count.\*\*\* The

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\* LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2664-65 (¶ 63); AT&T Price Cap Reconsideration Order, 6 FCC Rcd. at 674 (¶¶ 74-75); Investigation Order, 7 FCC Rcd. at 2725 (¶ 6).

\*\* Under price caps, the PCI is adjusted at least annually. LEC Price Cap Order, 5 FCC Rcd. at 6792, 6821-22 (¶¶ 47, 288).

\*\*\* The burden is on the LECs to show the absence of double counting. LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2668 (¶ 69). To remove the double count, either of two methodologies may be employed. The SFAS 106 accrual can be adjusted downward for the

magnitude of this double recovery needs to be determined and subtracted from the amount of the OPEB accrual benefits afforded exogenous treatment.

A. Godwins' Study Of The Double Count Is Seriously Flawed.

To demonstrate that the cost change they propose will not be reflected in GNP-PI, most of the price cap LECs rely on the Godwins' actuarial and macroeconomic analyses.\* Godwins estimates that only 0.7% of the SFAS 106 costs will be recovered through GNP-PI; it also concludes that suppression of national wage rates of 0.93% will occur (compared to the level to which wage rates would have risen in the absence of SFAS 106 accounting) and that this would equate to recovery of 14.5% of the additional SFAS 106-incurred costs. Other than Bell

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double count by either (1) removing the impact that SFAS 106 has on GNP-PI as firms increase their prices to reflect their OPEB liability (the approach used by all the LECs), or (2) removing the impact that GNP-PI has on the LECs' SFAS 106 accruals through the health care inflation component of the accrual (the approach recommended by AT&T).

- \* Peter J. Neuwirth and Andrew B. Abel, United States Telephone Association, Analysis of Impact of FAS 106 Costs on GNP-PI (1992) ("Godwins Study"). The method Godwins used to estimate the effects of SFAS 106 on GNP-PI is summarized in Appendix B hereto. (The Godwins Study is appended in full as Attachment B to Bell Atlantic's Direct Case.) All of the LECs who are parties to this investigation, other than Pacific and Rochester, rely on the Godwins Study. Pacific and Rochester rely on the NERA Study, which is addressed in Appendix C.

Atlantic, all of the LECs relying on Godwins then remove both components of the double count ( $0.7\% + 14.5\% = 15.2\%$ ) from their estimate of SFAS 106 expense, seeking exogenous recovery of 84.8% of their accruals.\*

The Godwins Study, however, is seriously flawed and should not form the basis for concluding that these carriers have eliminated the double count. First, the results of the Godwins Study depend on the calculation that the adoption of SFAS 106 will increase labor costs by 3% for firms incurring OPEB expenses. The 3% estimate is derived using numerous factors each subject to error as noted in Godwins' section on sensitivity of results (pp. 34-43). The cumulative impact of reasonable variations in each factor renders the 3% estimate suspect. If, for example, as shown in the Godwins Study

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\* Bell Atlantic (pp. 27-28) chose not to reduce its accrual by the 14.5% additional SFAS 106 cost recovery through wage suppression, characterizing it an endogenous issue because the Commission's price cap rules would not allow exogenous treatment of any negotiated or mandated wage increases. Therefore, Bell Atlantic claims it should not be expected to include reductions in wage growth rates in determining SFAS 106-related costs. The issue here is not wage rates *per se*, but rather the identification of all cost impacts (both positive and negative) resulting from the introduction of SFAS 106. Godwins states that this 0.93% wage suppression is the effect on the average employer (including LECs) which, similar to changes in GNP-PI, results in diminishing the impact of SFAS 106 for all employers and need not be recovered through PCI adjustment. Therefore, the additional macroeconomic effect on wages of at least 14.5% must be removed from Bell Atlantic's total OPEB costs that may be considered exogenous in nature to avoid double counting.

(p. 41), SFAS 106 results in a 5% increase in labor costs, the impact on GNP-PI increases to 1.9% from 0.7% (an increase of 170%), and the wage rate suppression effect increases to 23.4% from 14.5% (an increase of more than 60%). In short, a higher than 3% increase in labor costs would dramatically increase the OPEB expenses reflected in GNP-PI, thereby reducing the amount of LEC SFAS 106 expense potentially eligible for exogenous treatment.

Second, Godwins offers no methodology to test the validity of the macroeconomic model's results, as Godwins itself admits.\* For example, there is no way to independently verify by observation the true change in GNP-PI due to SFAS 106 even after SFAS 106 goes into effect. Standard economic practice is to perform tests whenever a model is based on estimates to see how closely the model mirrors actual data. Godwins omits from its study a description of what tests for validity may have been performed. If the model parameters and equations do not adequately describe real world data, then any predictions it gives are of little value.

Third, the validity of the macroeconomic model is further called into question because of the great sensitivity it exhibits to changes in assumptions. For example, altering the baseline assumption of labor elasticity from zero to an elasticity of 0.1 increases the

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\* See USTA Direct Case, Godwins Attachment, Response to Paragraph 16 of FCC Order of Investigation and Suspension (1992), at 7.

impact on GNP-PI by more than 400% (a .0642% impact vs. the .0124% base case impact) (p. 39). Moreover, Godwins' analysis looks at changes in parameter values on a "one at a time" basis (p. 38). This procedure, however, effectively eliminates sensitivities that might result from a combination of changes in parameter assumptions. More realistic scenarios would allow several interdependent parameter values to change at the same time, such as labor supply elasticity and demand elasticity for goods. The large variations in the models' results when parameter values are changed one at a time suggest that the model exhibits little stability when several assumptions are allowed to vary simultaneously.\*

Fourth, the study is flawed because the government sector is not included. Although SFAS 106 does not affect the accounting practices of the government, growth in retirement health care costs for the government sector of the economy will affect the growth in GNP-PI, because GNP-PI includes government SFAS 106-like OPEB

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\* There is no discussion in the Godwins Study about how its results would be affected by changes in the model's functional or mathematical form. Economic theory can suggest several types of functional forms, or equations, each of which would yield different results. For example, the equation Godwins uses to describe the relationship between inputs and outputs is known as the Cobb-Douglas production function. This functional form places severe restrictions on the substitutability of labor and capital which, together with the high price elasticity of -1.5, may explain why the Godwins' model has such an unrealistically low pass-through coefficient of 2.3% (pp. 10, 29).



expenses. Failing to include the government sector in the actuarial and macroeconomic models would also therefore result in understating the amount of OPEB-related costs that are reflected in the GNP-PI. If OPEB-related expenses of the government were included in the analyses, the GNP-PI would be higher, and this would have the effect of reducing the amount of the LECs' SFAS 106 expense potentially eligible for exogenous recovery.

These flaws render the measurement of the GNP-PI impact through Godwins' study unreliable.\* In short, the LECs have failed to demonstrate that their SFAS 106 accruals will not be recovered through the GNP-PI component of the price cap formula.

B. The Commission Should Require The LECs To Remove The Double Count From The SFAS 106 Accrual Using The Method Suggested Herein.

For the reasons shown above and in Appendix C, neither the Godwins nor NERA studies can be considered to have adequately removed the double count from the LECs' SFAS 106 accruals. Because the SFAS 106 accrual is inherently imprecise and measurement of its impact on the economy is extremely difficult to assess, it is not

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\* As shown in Appendix C, the NERA Study, on which Pacific and Rochester rely, is also flawed. If NERA's assumptions are made more realistic, the amount of SFAS 106 expense that these companies would recover through GNP-PI increases substantially.

possible to predict the full extent that SFAS 106 will affect prices in the economy generally (as both Godwins and NERA attempt to do).\*

Therefore, the Commission should require the LECs to use an alternative approach that is both a simpler and more reliable means for correcting the double count. AT&T suggests that the appropriate method for removing the double count between the SFAS 106 accrual and the GNP-PI term in the price cap formula is to remove the impact of expected changes in GNP-PI from the SFAS 106 accrual. This can be accomplished in a straightforward manner by requiring the LECs to subtract the expected rate of change of GNP-PI from the health care inflation component in the SFAS 106 accrual.\*\* The Commission should specify the

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\* The American economic system is so complex that it is almost impossible to isolate with any degree of precision the relatively small and diffuse impacts created by a change in an accounting standard, such as SFAS 106, on prices in the general economy.

\*\* Inflation enters the SFAS 106 accrual calculation through the health care trend term which captures, in addition to other effects, the effect of increases in the prices of medical goods and services. If the general rate of inflation increases, the rate of health care inflation (which includes general inflation plus influences that are specific to the health care sector) would also increase. For instance, if four percentage points (approximately the expected long-term rate of inflation) are subtracted from Pacific's health care trend rate, AT&T's model of Pacific's SFAS 106 accrual indicates that Pacific's accrual would be reduced 45%; thus, only 55% of Pacific's proposed accrual would qualify for exogenous treatment. See Part III, infra, and Appendix F, p. 11.

changes in GNP-PI over the SFAS 106 forecast period.\* Current estimates, is that GNP-PI will increase approximately 4% over the long-term.\*\* This avoids the numerous unverifiable assumptions used in the Godwins and NERA studies.

II. ONLY PREFUNDED OPEB COSTS SHOULD BE CONSIDERED FOR EXOGENOUS TREATMENT.

To be eligible for exogenous treatment, the Commission should require the LECs to prefund the permissible accrual amount to ensure that amounts paid by ratepayers are used only for the purpose for which exogenous treatment was granted. This condition is needed because there are no requirements in GAAP, in the regulatory accounting rules, or in price cap regulation

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\* Forecasts of the Gross Domestic Product-Price Index ("GDP-PI"), which is virtually identical to GNP-PI, are available from economic consulting firms, such as The WEFA Group ("WEFA"). WEFA currently forecasts that GDP-PI will increase an average of approximately 4% from 1993 through 2010 (see Appendix D, p. 1). The GDP-PI and GNP-PI have had virtually identical values over the last 10 years (see Appendix D, p. 2), and therefore the forecasted GDP-PI can be substituted for the GNP-PI in the proposed approach for correcting the double count.

\*\* Appendix D, p. 1. The calculation of this offset should be performed after the LECs have otherwise resized the parameters used to calculate their SFAS 106 accruals, as suggested in Part III, infra. If, for any reason, the Commission does not require the LECs to resize their accruals utilizing the parameters suggested in Part III, it should, at a minimum, require them to recalculate their filed SFAS 106 accrual amounts after deducting the 4% GNP-PI figure from the health care inflation factor in the accrual.

that would prevent a carrier from recovering SFAS 106 accrual costs and in the future reducing the actual benefits paid. In fact, there is no requirement that these funds ever be used to pay OPEB costs at all.

The LECs should be required to show that the pricing changes and resultant revenues generated through inclusion of OPEB accruals as an exogenous cost will be used exclusively for the purpose they were intended. Therefore, a requirement should be established that limits the amount to be considered for exogenous treatment to the amount that the carrier actually prefunds, less any amounts already reflected in their price cap indexes, whether funded or not.\* Of the several funding vehicles available, the tax-effective ones, such as Internal Revenue Code Section 501(c)(9) VEBA Trusts, 26 U.S.C. § 501(c)(9), generally forbid removal or transfer of funds except for the purpose for which they were established. Most of the LECs indicate in their direct cases that they have some VEBA or similar trusts in place to fund a portion of their OPEB costs.\*\* A mandatory prefunding

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\* Most LECs included some level of SFAS 106 accrual accounting costs beyond "pay-as-you-go" amounts prior to price caps, and these amounts are already reflected in their PCIs. LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2664 (¶ 62). See, e.g., Bell Atlantic 4/2/90 Annual Access Filing, Cost Support, Vol. 2-1, p. 3-12; U S WEST 4/2/90 Annual Access Filing, Cost Support, Vol. 2-1, p. 3-5.

\*\* Ameritech, p. 18; Bell Atlantic, pp. 16-17; BellSouth, pp. 12-15; GTE, p. 9 and Att. IV; Pacific, pp. 11-12; NYNEX, pp. 24-26; SNET, pp. 9-10; SWBT, p. 23; U S WEST, p. 11.

requirement for all price cap LECs will safeguard that amounts paid by ratepayers are only used for the purpose for which exogenous treatment was granted.

III. SOME LIMITATIONS SHOULD BE PLACED ON THE LECs' SFAS 106 ACCRUALS FOR EXOGENOUS PRICE CAP TREATMENT PURPOSES.

Regardless of whether there is double counting of OPEB-related costs, as a general matter, full exogenous treatment should not be given to the LECs' SFAS 106 accruals. Rather, as shown below, some limitation on the LECs' SFAS 106 accruals is needed to ensure that the exogenous price increase is held to a reasonable level. A limitation is appropriate because OPEB costs are to some measure within the LECs' control, OPEB accrual amounts are highly speculative, and full exogenous treatment could give LECs an unwarranted windfall. Therefore, as discussed at pp. 25-29, *infra*, the Commission should limit the LECs' OPEB accruals for pricing purposes by adopting certain parameters (*e.g.*, as to capping of postretirement health care benefits) that all LECs would use in calculating the amount of their OPEB expenses that would be entitled to exogenous treatment. The LECs would, of course, remain free to offer their employees whatever OPEB benefits they deem appropriate and to reflect the full amount of the associated SFAS 106 accruals on their regulated income statements.

A limitation on the amount of the SFAS 106 accrual afforded exogenous treatment is needed, first, because, although SFAS 106 accounting treatment is mandatory,\* the underlying OPEB expense is not totally outside of the LECs' control, and the LECs should be provided with the proper incentives to become more efficient in this area. OPEB is one aspect of an employee's total compensation package, and the LECs have essentially the same degree of control over OPEB expenses as over salaries and wages, which are treated endogenously.\*\* At least for currently active employees,

\* Bell Atlantic (pp. 7-8), however, improperly seeks to include as an exogenous cost OPEB benefits accrued since January 1, 1991, the effective date of its adoption of SFAS 106 for regulatory accounting purposes. Bell Atlantic opted to implement SFAS 106 earlier than the January 1, 1993 mandatory effective date at its own discretion; it was not required to do so either by the FCC or by the FASB. Therefore the portion of incremental SFAS 106 costs which Bell Atlantic incurred for the period prior to January 1, 1993 does not qualify for exogenous treatment. See AT&T SFAS 106 Order, 5 FCC Rcd. at 3680. Moreover, inclusion of such costs for any period prior to the current tariff period would violate the Commission's policy against retroactive ratemaking. If Bell Atlantic were allowed exogenous treatment for all its SFAS 106 accruals effective January 1, 1993, its SFAS 106 cost would be approximately \$10 million for the January 1, 1993 to June 30, 1993 tariff period, as compared to the \$50 million which it now seeks for that period.

\*\* For current management employees, carriers have virtual unilateral control over the offering of OPEB benefits. For current employees covered by labor agreements, the employer must honor contractual commitments as to OPEB, but only through the life of

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the LECs have substantial ability to control both the level of benefits offered to employees, and they further retain the ability to alter, cap or even withdraw these benefits in the future.\*

In similar contexts, the Commission has refused to grant any exogenous cost treatment, on the ground that it would be contrary to price cap policy. For example, despite the fact that depreciation rates are expressly set by the FCC and not by carriers, the Commission stated:

" . . . the major determinant of the rate of depreciation is the service life of plant. It is the carrier, and not this Commission, that . . . primarily controls the rate at which plant investment is translated into depreciation expense. The influence which a carrier exercises over its depreciation expense thus differs both in degree and in kind from the influence which the carrier has over truly exogenous cost factors . . . ."\*\*

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the contract. All such benefits are subject to renegotiation in replacement contracts, and employers can and do successfully reduce or curtail such benefits in exchange for job security, training, or other current labor needs. See, e.g., Ameritech, p. 2. The LECs can also control OPEB costs through their ability to adjust employee force levels.

\* See BellSouth Direct Case, Appendix 5, "The BellSouth Medical Assistance Plan, Summary Plan Description," p. ii (January 1990). Indeed, carriers may also have the ability to affect the amount of benefits made available to already retired employees. Id.

\*\* Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873, 3015 (¶ 290) (1989) ("AT&T Price Cap Order"); LEC Price Cap Order, 5 FCC Rcd. at 6809 (¶ 182).

Similarly here, the control that the LECs have over their OPEB programs justifies limiting their SFAS 106 accruals for purposes of exogenous treatment.

Indeed, a limitation on exogenous treatment is essential to provide the LECs with the proper incentives to increase their efficiency. As the Commission stated with respect to depreciation,

"Even more important than the question of degree of control, however, is the question whether exogenous cost treatment of depreciation rate changes is consistent with the concept of incentive regulation. The idea behind price caps is to provide [carriers] with the proper incentives toward efficiency and productivity . . . . If we essentially guarantee recovery of one of the types of costs, i.e., depreciation expense . . . we distort the process. . . . If, on the other hand, we require the carrier to live with the depreciation rates that result from its investment decisions, then we can feel more assured that it is making those long term decisions in ways that will enhance productivity in the long run."\* (emphasis supplied)

As with depreciation expense, giving exogenous treatment to the full amount of the actuarially determined value of SFAS 106 OPEB accruals would eliminate the incentives that LECs would otherwise have to manage postretirement health care costs efficiently, because cost recovery of this expense would be assured. Moreover, as the Commission has

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\* AT&T Price Cap Order, 4 FCC Rcd. at 3016 (¶ 291); LEC Price Cap Order, 5 FCC Rcd. at 6809 (¶ 183). Similarly, the Commission determined that it would treat international accounting rate changes as endogenous to provide AT&T with the proper incentive to negotiate lower rates. AT&T Price Cap Order, 4 FCC Rcd. at 3018 (¶ 297).



previously recognized, granting exogenous treatment to an expense could create perverse incentives for the LECs to inflate that expense,\* contrary to the Commission's goals to encourage carriers to control their administrative costs.\*\*

The LECs' direct cases confirm that some of these companies have already exercised their management prerogative to implement cost controls through capping OPEB medical benefit payment levels or imposing cost-sharing requirements on their employees.\*\*\* There are, however, large variations among the LECs in capping their OPEB benefits. For example, SNET's caps will not take effect until 1996, whereas BellSouth's are already in force. U S WEST's caps require employees to share only 20% of future medical cost increases, whereas BellSouth freezes the company's contribution at 1990 levels. Rochester and GTE appear not to have any caps in place; and NYNEX is uncertain as to its plans for capping benefits.\*\*\*\* In short, the significant differences in

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\* LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2666-67 (¶ 66) (discussing LEC equal access costs).

\*\* LEC Price Cap Order, 5 FCC Rcd. at 6790 (¶ 31).

\*\*\* See, e.g., Ameritech, p. 21; Bell Atlantic, p. 26; BellSouth, pp. 18-19; Pacific, p. 18 and App. 7, p. 20.

\*\*\*\* BellSouth, pp. 18-19; NYNEX, Att. B; Rochester, p. 27; SNET, p. 12; U S WEST, Att. F, Tables 91-2 and 91-3.